

# The Administrative Expenses the National Heritage Insurance Company Charged to the Health and Human Services Commission

January 31, 2003

Members of the Legislative Audit Committee:

Our audit of the administrative expenses that the National Heritage Insurance Company (NHIC) charged to the Health and Human Services Commission (Commission) in fiscal year 2001 has led us to conclude that NHIC should refund \$15,841,385 in unallowable expenditures it inappropriately charged to the Commission for processing Medicaid claims in fiscal year 2001. This amount includes the following:

- \$13,464,734 for unallowable expenditures. NHIC did not make these expenditures in compliance with contract terms. For example, some expenditures were unallowable because they were associated with NHIC's development of Compass 21 (a new Medicaid claims processing system that NHIC created for the Commission). Others were unallowable because they were for NHIC employee relocation expenses or were for expenditures that NHIC made prior to fiscal year 2001.
- \$1,512,991 in unallowable employee payroll, bonus, and overtime costs. The majority of this refund is necessary because NHIC inappropriately charged the Commission for payroll and bonuses associated with the development of Compass 21.
- \$821,118 in unallowable depreciation costs. This refund is necessary because NHIC (1) inappropriately accelerated the depreciation of assets and (2) inappropriately charged the Commission for depreciation on assets it used to develop Compass 21.
- \$42,542 in unallowable insurance license costs. This refund is necessary because NHIC did not properly allocate the cost of its insurance license among all of the contracts that require it to have this license. The \$42,542 refund is in addition to the \$307,599 that NHIC already refunded to the Commission because of this issue.

The attachment to this letter contains additional details on the amounts listed above. The population of NHIC expenditures we audited did not include the unallowable expenditures that NHIC had already identified. Therefore, the \$15,841,385 amount that NHIC should refund to the Commission does not duplicate expenditures that NHIC had already identified as unallowable.

The \$15,841,385 amount that NHIC should refund to the Commission does not include the general and administrative fee and markup fee that NHIC charged the Commission related to these expenditures. The current general and administrative fee NHIC charges to the Commission is 9.4116 percent of total expenditures, but that rate is subject to change pending the results of a federal audit. The markup fee NHIC charges the Commission is 15 percent of the sum of total expenditures and the general and administrative fee.

#### Objective, Scope, and Methodology

Our objective was to determine the validity of charges that NHIC charged the Commission in fiscal year 2001 to administer Medicaid claims. Our agreement with the Commission specified additional objectives that we continue to pursue. The additional objectives include auditing the administrative expenditures that NHIC charged to the Commission in fiscal year 2002, accounts receivable balances that providers owe to the State, the accuracy of claim counts, and certain reserve and stabilization fund balances.

For this report, our scope was administrative expenditures that NHIC charged to the Commission in fiscal year 2001 (excluding expenditures that NHIC had already identified as unallowable). We will audit fiscal year 2002 administrative expenditures as we pursue the remaining objectives specified in our agreement with the Commission.

The audit methodology consisted of collecting information, performing selected audit tests and other procedures, and analyzing and evaluating the results against established criteria. This audit was conducted in accordance with generally accepted government auditing standards.

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When the general and administrative fee is finalized, NHIC should refund the Commission for the amount of the general and administrative fee and markup fee associated with the \$15,841,385 in unallowable expenditures we identified.

This report does not include determinations we made as a result of auditing (1) the contract costs for fiscal year 2002, (2) accounts receivable balances that providers owe to the State, (3) the accuracy of claim counts, and (4) certain reserve and stabilization fund balances. Our work in these areas is ongoing.

The Commission has reviewed the findings contained in this report and will take action on these findings.

We thank the Commission for its cooperation during this audit. If you have any questions, please contact Joanna B. Peavy, CPA, Audit Manager, at (512) 936-9500.

Sincerely,

Lawrence F. Alwin, CPA  
State Auditor

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Attachment

cc: Mr. Albert Hawkins, Commissioner, Health and Human Services Commission

# Detailed Results

Chapter 1

## NHIC Should Refund \$13,464,734 in Unallowable Expenditures It Charged to the Commission

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### Summary

Based on the results of our random sample testing, we project that the National Heritage Insurance Company (NHIC) should refund \$13,464,734 in unallowable expenditures that it charged to the Health and Human Services Commission (Commission) in fiscal year 2001.

We derived our audit conclusions from testing a random sample and projecting the results over the entire population of expenditures. To support this conclusion, we also reviewed a judgmental sample, which showed similar errors. The three primary reasons the expenditures were unallowable include the following:

- The expenditure was for the development of Compass 21 (a new Medicaid claims processing system that NHIC created for the Commission), but NHIC charged it to Operations (the unit that administers Medicaid claims). Examples of these expenditures include:
  - ♦ \$6,200 that NHIC paid to one information technology contractor in June 2001. Although NHIC charged this expenditure to Operations, NHIC's documentation indicates that the contractor associated with this expenditure was working on the development of Compass 21.
  - ♦ \$247,563 in expenditures (primarily contracted professional services) that NHIC documentation indicates were directly associated with Compass 21 development. For example, we obtained and reviewed the purchase orders for some of the contracted professional services and identified one purchase order for \$3.9 million that explicitly specified it was for Compass 21 development. NHIC amended this purchase order multiple times, and each amendment was for work it performed on the development of Compass 21.

#### Summary of Our Sampling and Projection Methodology

To sample expenditures and project the results to the population, we did the following:

- We selected a random sample of 29 transactions (totaling \$92,967.68) from the population of expenditures that NHIC charged to the Commission in fiscal year 2001. The population from which we drew our sample excluded payroll and payroll-related items, depreciation, and expenditures already identified by NHIC as unallowable under the Federal Acquisition Regulation (FAR). To determine the sample size of 29, we set our confidence level at 95 percent and selected a 10 percent desired level of sampling precision.
- We tested the 29 transactions in our sample for allowability and determined that 5 of them were unallowable.
- Based on our test results, we projected that the total refund should be \$13,464,734.

- The expenditure did not occur in fiscal year 2001, but NHIC charged it to fiscal year 2001. Examples of these expenditures include:
  - ♦ \$290,660 in expenditures that NHIC made prior to fiscal year 2001, and prepaid expenses for items such as software licenses and hardware maintenance contracts that extended into fiscal year 2002 but that NHIC charged to the Commission in fiscal year 2001.
  - ♦ \$77,066 for the purchase of a phone system that NHIC should have capitalized and depreciated over its useful life, rather than categorizing it as an expense. An accounting policy set forth by the Electronic Data Systems Corporation (EDS), NHIC's parent company, specifies that purchased property and equipment should be capitalized if the historical cost of the asset is greater than or equal to \$500 and the useful life of the asset is greater than 12 months.
- The expenditure involved unallowable relocation expenses that NHIC charged to the Commission. These expenditures include:
  - ♦ \$35,846 in rent that NHIC paid for an apartment in which the NHIC Chief Operating Officer resided. This amount was for rent that NHIC paid beyond the two months allowed by federal regulations.
  - ♦ \$91,668 that NHIC charged to the Commission for the NHIC Chief Operating Officer's estimated relocation expenses. A portion of these expenses is unallowable. In addition, NHIC charged the Commission for the estimated relocation expenses of \$91,668 rather than for the actual relocation expenses of \$90,494. Based on available documentation, actual expenses included:
    - \$21,503 to ship items from South Africa to Austin.
    - \$21,450 for storage of the shipped items.
    - \$32,723 for expenses associated with selling a home and \$5,047 for expenses associated with buying a home. NHIC transferred the Chief Operating Officer from South Africa to Austin. However, the house that the Chief Operating Officer sold was located in Argyle, Texas. Therefore, NHIC should be allowed to charge the Commission only for either the Chief Operating Officer's moving expenses or the Chief Operating Officer's home-selling and home-buying expenses, but not both.
    - \$9,771 in tax assistance. The tax assistance is unallowable under Federal Acquisition Regulation (FAR), and NHIC's own documentation also identifies this tax assistance as unallowable.
  - ♦ \$27,666 in seller incentives and income taxes on these incentives for two other employees that NHIC relocated to Austin.

As we continue this audit, we may identify additional Compass 21 expenditures that NHIC charged to the Commission in fiscal year 2001. We will report any additional Compass 21 expenditures we identify.

Chapter 2

## **NHIC Should Refund \$1,512,991 in Employee Payroll, Bonus, and Overtime Costs It Charged to the Commission**

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### **Summary**

NHIC should refund \$1,512,991 in employee payroll, bonus, and overtime costs it inappropriately charged to the Commission. The majority of these costs were associated with the development of Compass 21.

The payroll, bonus, and overtime costs that NHIC should refund include the following:

- Between July 2001 and August 2001, NHIC inappropriately reassigned 195 NHIC employees from Compass 21 development to Operations. NHIC charged the Commission \$908,632 for the payroll costs associated with these 195 employees for the month of August 2001. Prior to July 2001, but during fiscal year 2001, NHIC also reassigned 19 NHIC employees from Compass 21 development to Operations. NHIC charged the Commission \$540,609 for the payroll costs associated with these 19 employees.
- During fiscal year 2001, NHIC inappropriately charged the Commission for \$43,708 in bonuses that NHIC paid to NHIC employees who worked on Compass 21 development.
- During fiscal year 2001, NHIC inappropriately charged the Commission for \$20,042 in overtime pay that it gave to NHIC employees who were exempt from Fair Labor Standards Act (FLSA) requirements. NHIC's contract with the Commission allows it to charge the Commission for overtime pay only for employees who are *not* exempt from FLSA requirements.

NHIC prepared manpower allocation percentage reports to allocate "manpower months" to Compass 21 development and Operations. Based on historical trends indicated in those reports, NHIC has not supported that these employees worked to process Medicaid claims or that it needed 195 additional employees when it began using Compass 21 in August 2001. For example, as Table 1 shows, when the number of claims NHIC processed increased 13.38 percent from fiscal year 1999 to fiscal year 2000, the manpower months NHIC used to process those claims increased by 4.49 percent. In comparison, however, after the Commission began using Compass 21, the number of claims it processed increased by 16.27 percent, but the manpower months NHIC used to process those claims increased by 21.35 percent.

**Definition of a  
Manpower Month**

One manpower month equals the total number of days available to work in a month multiplied by eight hours per day.

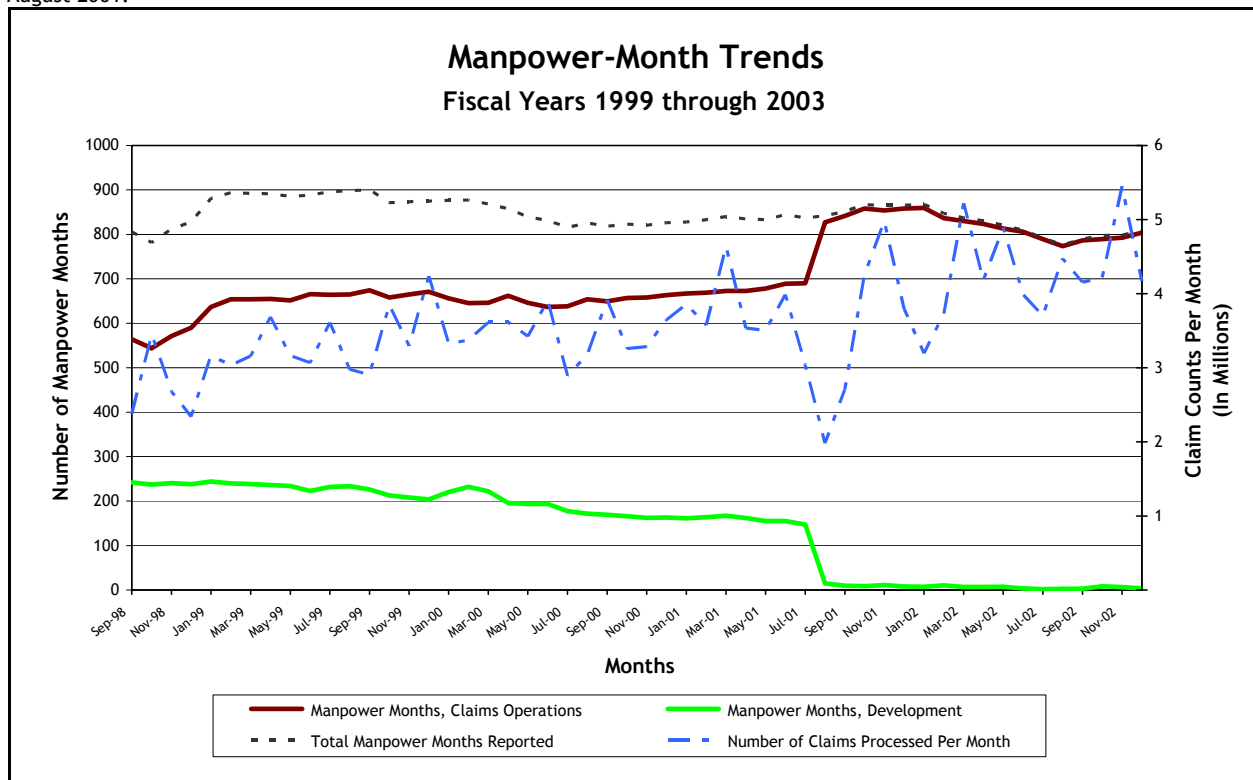
Table 1 - The number of manpower months NHIC used to process Medicaid claims after the Commission began using Compass 21 in August 2001 increased significantly.

Manpower Months NHIC Used to Process Medicaid Claims							
	Fiscal Year 1999	Fiscal Year 2000		Fiscal Year 2001		Fiscal Year 2002	
		Fiscal Year 2000	Increase from Fiscal Year 1999	Fiscal Year 2001	Increase from Fiscal Year 2000	Fiscal Year 2002	Increase from Fiscal Year 2001
Number of Medicaid claims NHIC processed	36,690,801	41,599,975	13.38%	42,219,843	1.49%	49,089,325	16.27%
Manpower months NHIC used to process Medicaid claims	7,514.58	7,852.00	4.49%	8,193.00	4.35%	9,943.00	21.35%

Source: NHIC manpower, claims operations, infrastructure, and run-out allocations reports

As Figure 1 shows, the number of manpower months NHIC charged to Operations increased significantly in August 2001, but the number of manpower months it charged to Compass 21 development decreased significantly. However, the general trend in the growth of the number of claims processed each month did not change significantly.

Figure 1 - The number of manpower months NHIC charged to Compass 21 development and Operations changed significantly in August 2001.



Source: NHIC manpower allocation percentage, claims operations, and infrastructure run-out allocations reports

We based our analysis of payroll on the manpower reports that NHIC uses to allocate payroll costs to Compass 21 development and Operations.

## **NHIC Should Refund \$821,118 in Depreciation Costs It Charged to the Commission**

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### **Summary**

NHIC should refund a total of \$821,118 in depreciation costs that it inappropriately charged to the Commission. NHIC overcharged the Commission for depreciation in two ways.

#### **Contractual, Regulatory, and EDS Policy Requirements Regarding Asset Depreciation**

- A 1997 memo NHIC wrote as part of its negotiations to administer Medicaid claims in Texas specified that NHIC would charge depreciation “through month 60 of the contract but not beyond.” The original term of NHIC’s contract with the Commission was 48 months (September 1998 through August 2002), with four one-year options.
- NHIC’s contract with the Commission specifies that certain federal regulations—Code of Federal Regulations, Title 48, Subpart 31.2 (Contracts with Commercial Organizations), and Chapter 99 (Cost Accounting Standards)—govern the allowability of costs it can charge the Commission to administer Medicaid claims. These regulations specify that:
  - ♦ Depreciation is a charge to current operations that distributes the cost of a tangible asset over the useful life of the asset in a systematic and logical manner.
  - ♦ Depreciation costs should be a reasonable measure of the expiration of service potential of the asset. The service life is the period of usefulness of a tangible asset.
- A contract amendment to extend NHIC’s contract with the Commission through February 2004 specified that NHIC should depreciate assets over their standard useful life. The amendment allowed NHIC to charge for the full asset only if, at the end of the contract, the State retained the asset.
- EDS Accounting Policy 003-060 states that:

“The cost of all capitalizable assets should be depreciated over the estimated useful lives of the assets.... The entire asset value must be depreciated within the contract model. If the contract life is shorter than the asset life, the remaining net book value of the asset must be expensed in the last month of the contract model.”
- Both EDS’s asset useful life table and NHIC’s GIT/Property Category Cross Reference table specify that the useful life of computers and computer-related equipment is 60 months.

NHIC’s contract with the Commission and federal regulations cited within that contract require NHIC to depreciate assets over their useful life. The contract allows NHIC to charge the Commission for depreciation on assets (primarily computers and computer-related equipment) it uses to administer Medicaid claims. However, NHIC inappropriately accelerated depreciation on assets it acquired during and after April 2000. Instead of depreciating those assets over what it normally considered to be the assets’ useful life (60 months), NHIC depreciated them over the remainder of the term of its contract with the Commission.

As of April 2000, 28 months remained on NHIC’s contract with the Commission. Therefore, even if the useful life of an asset NHIC acquired in April 2000 was 60 months, NHIC accelerated the depreciation of that asset so that it could fully depreciate the asset within 28 months. As a result, NHIC charged the Commission for depreciation costs that were higher than its contract and federal regulations permitted (see text box for additional details). NHIC did not inform the Commission of its decision to accelerate the depreciation of assets. The amount of the overcharge resulting from NHIC’s acceleration of depreciation was \$670,388.

NHIC’s contract with the Commission also does not permit NHIC to charge the Commission for depreciation on assets (primarily computers and computer-related equipment) it used to develop Compass 21. However, after the Commission began using Compass 21, NHIC inappropriately charged the Commission \$150,730 for depreciation on those assets.

## **NHIC Should Refund an Additional \$42,542 in Insurance License Costs It Charged to the Commission**

### **Summary**

NHIC should refund an additional \$42,542 in fiscal year 2001 insurance license costs to the Commission. The \$42,542 refund is in addition to the \$307,599 that NHIC already refunded to the Commission for insurance license costs that it erroneously charged to the Commission.

NHIC maintains an insurance license in the state of Texas to satisfy its contractual agreement to serve as the State's Medicaid claims administrator. However, NHIC also uses its Texas insurance license to satisfy insurer requirements within the Medicare contracts it has with other states. Therefore, NHIC must allocate the cost of its insurance license among all of the contracts that require it to have this license.

In fiscal year 2001, NHIC incurred \$630,911.91 in costs related to its insurance license (see text box for the components of that amount). Initially, NHIC erroneously billed *all* of those costs to the Texas Medicaid contract. After the error was detected, NHIC allocated a portion of those costs to its Texas Medicaid contract based on the ratio of that contract's expenses to the total expenses associated with all of its contracts (i.e., the Texas Medicaid contract and the Medicare contracts it has in other states). As a result of that allocation, NHIC refunded \$307,599 in May 2002 to the Commission for fiscal year 2001.

<b>NHIC Fiscal Year 2001 Costs Related to Its Texas Insurance License</b>	
Internal Billing Transfer (Regulatory Reporting, Treasury Reporting, Treasury Operations)	\$524,716.47
Accounting	62,641.68
Actuarial Fees	8,371.51
Legal Fees	35,182.25
<b>Total</b>	<b>\$630,911.91</b>

Source: NHIC license costs schedule

During our audit, we identified two additional errors in NHIC's allocation of its insurance license costs to the Texas Medicaid contract. These two errors require NHIC to refund an additional \$42,542 to the Commission:

- NHIC erroneously included its development costs for Compass 21 and unallowable costs in the total Texas Medicaid contract costs. Compass 21 development costs should not have been included in the allocation calculation for two reasons: (1) the insurance license was not required for the development of Compass 21, and (2) Compass 21 development should have been complete in May 2000. Correcting this error will require NHIC to refund \$42,032 to the Commission.<sup>1</sup>

<sup>1</sup> This calculation is based on NHIC's reporting of unallowable expenses. If additional expenses are identified through this audit, the allocation of insurance license costs will also change.



- We also discovered certain calculation errors in NHIC's billings to the Commission. These errors affected NHIC's allocation of its insurance license costs to the Texas Medicaid contract. Correcting these errors will require NHIC to refund \$510 to the Commission.

#### **Cost Savings Associated with Changing to a Fiscal Agent Arrangement**

Texas first selected the insured arrangement as the method for contracting with its Medicaid claims administrator in the 1970s. The arrangement requires the claims administrator to have an insurance license. This was reflected in the provision in the Commission's contract with NHIC that required NHIC to have the ability to bear risk.

However, based on our review of contract documentation and interviews with NHIC, the Commission, and the Department of Insurance, it appears that the functions of the Medicaid claims administrator no longer require it to actually bear any risk that would require an insurance license. The Commission's current proposal to discontinue the insurance license requirement and change to a fiscal agent arrangement with its new Medicaid claims administrator will eliminate future insurance license costs.